DOW THEORY LETTERS INC.

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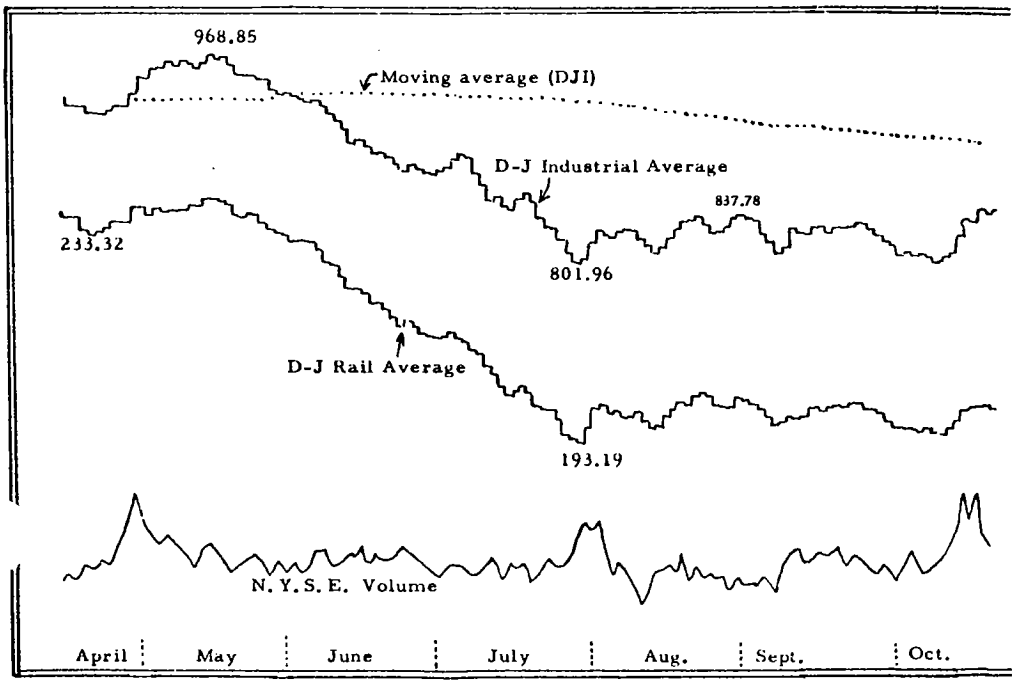
THE MARKET: On August 22 the Industrial Average struck a recovery peak of 837.18. On September 1 Industrials hit a second recovery peak at 837.78. Last week on October 16, Industrials recorded a third recovery peak of 838.77. As shown on the page 2 chart of the last Letter, these new recovery highs in the Dow have not been confirmed by the advance-decline line. In fact, the trend of the A-D ratio since August 22 has been to declining peaks, and this means a persistent divergence with the Industrial Average.

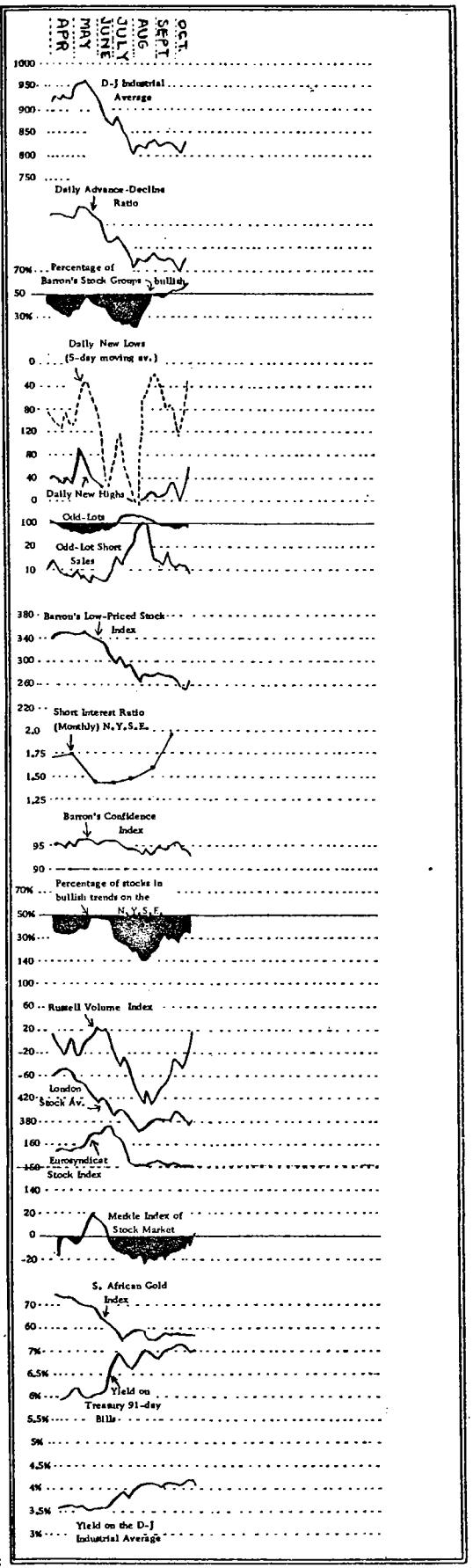
As this is written the Rail Average too has failed to confirm the latest bounce in Industrials. The post-July Rail peak was 202.02 recorded on August 22. So from the technical standpoint, it remains to be seen whether the A-D ratio and the Rail Average "come through" for a general confirmation of the recovery high recorded by Industrials.

Personally, I am of the opinion that this whipping back and forth by the market, with Industrials moving time and again between the 800 and 840 range, is a process of distribution. Each time a spate of hopeful news comes along the Industrials rush up 40 points; each time the news turns gloomy they descend again to the 800 level. It is a process calculated to keep the speculators hopeful and continuously on the buy, it is a process which keeps most investors loaded with wares.

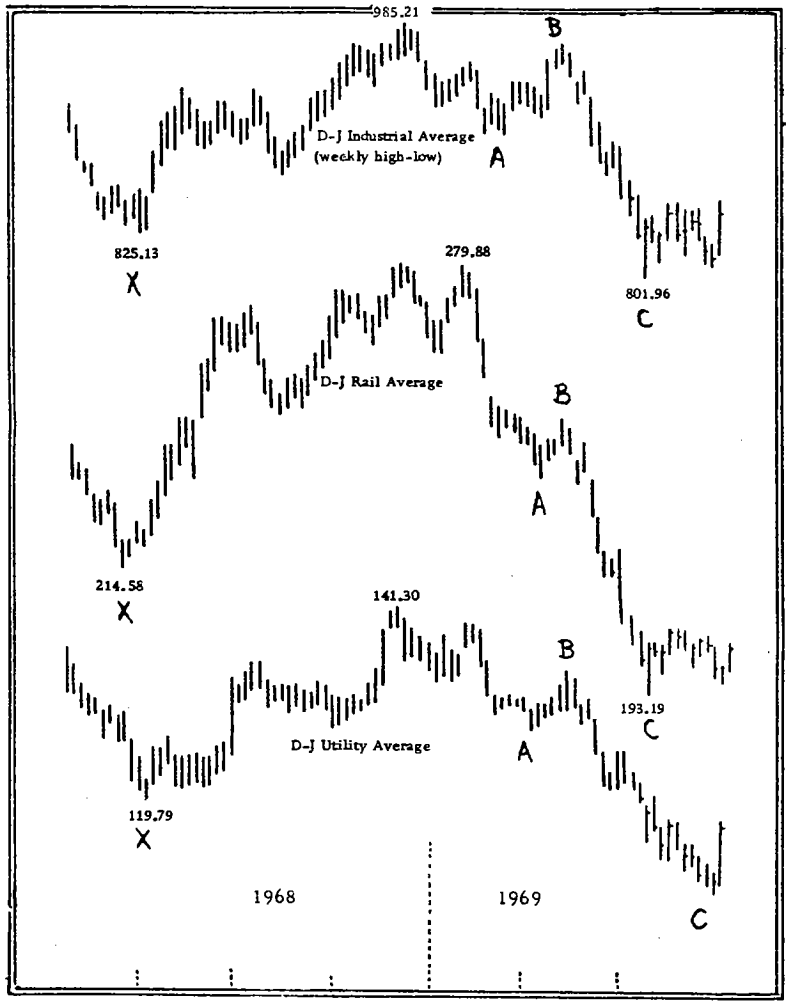
In the next section I have attempted to place the whole picture in larger perspective. The short-term view is now, as it usually is, overflowing with complexities and uncertainties.

THE AVERAGES: I have included a weekly chart (page 2) of the three D-J Averages; Industrials, Rails, Utilities. The long-term formations in each of these Averages are bearish. Note that in each case we have a sizeable decline to point "A", a correction lasting a number of weeks to point "B", then another extended decline below the "A" point down to point "C", the latter corresponding to the 1969 lows.





According to orthodox Dow Theory, the A-B-C formations constitute a bear signal. But since the original primary bear signal was provided during 1966, the A-B-C bear signals pictured on this chart merely reconfirm the weakness of the price structure and point to the new weakness which became apparent during 1969.



Aside from the implications of the "new 1968-69 bear signals" as shown on the chart, it is also significant that in each case the 1969 declines broke below the important 1968 secondary lows (these lows are marked with an "X" on the chart). Robert Rhea, the great Dow Theorist of the 1930's, noted that if a decline is underway and the Averages continue down and break below the preceding secondary lows, it is reasonable to consider that the primary trend has turned down. Since, in the case of each of the Averages, the decline from B to C broke below the 1968 lows at X, I consider this another important indication that a primary bear market is in effect.

Subscribers may be surprised that I picture the Utility Average on this chart. The Utilities, as far as Robert Rhea was concerned, played no part in Dow Theory. Since the Utility Average only came into being in 1929, neither Dow nor Hamilton ever had any familiarity with it. I do not know what Rhea would have concluded regarding Utilities if he were living today. Rhea died in 1939, only ten years after the Utility Average was developed, and he noted during the mid-1930's that there was not enough history of the Utility Indicator to draw any valid inferences—nor was he sure that another Average was needed to privide Dow Theory conclusions regarding the primary trend.

Personally, I do watch the Utility Average carefully, although I do not use the movements of the Utilities to provide any definite conclusions regarding the primary trend. I believe that the Utilities constitute a good confirmatory tool and that their movements should not be ignored. As a matter of fact, Utilities have often shown good "lead" characteristics. For instance, the Utility Average topped out in early 1965, a full year before the otherAverages struck their bull market peaks. Utilities turned up a month ahead of the other Averages from the 1966 lows. Utilities lagged badly during the 1967 and 1968 advance, and they turned down slightly ahead of the other Averages during late-1968.

I think it may be significant that the Utility Average is structurally now the weakest of the three Averages. It is the only Average to have broken below its 1966 low (comparable to a break by Industrials through the 744.32 low or a decline by Rails through the 184.34 low).

Thus, from the standpoint of the big picture we have the primary bear signal of 1966, the big rally back during 1967 and 1968, a new Rail high of 279.88 recorded on February 7, 1969 (a Rail high unconfirmed by Industrials) and finally the 1969 decline. It was during the 1969 decline that the Utility Average acted outstandingly bearish by penetrating its 1966 lows. If Utilities are still providing lead characteristics, the Industrials and Rails will, in time, penetrate their own 1966 lows, thus reconfirming the overall primary bear trend.

I want to warn readers again not to place too much credence on the short-term or daily fluctuations of the Averages. The daily or minor trends can be extremely deceptive, and this is particularly true during bear markets. In studying the daily chart of all past bear markets, I have noticed dozens and dozens of areas wherein the "implications" of the minor movements would have cost investors and speculators dearly.

BUY: I read approximately 20 advisory services and as many magazines and other publications each week. A good percentage of these arrive on Monday morning, and by Monday evening I am so groggy from reading it's a question of whether I'll be able to make it home or not.

But all that reading serves a purpose. It drives into my unconscience the general tenor and "feel" of what the professionals are saying. The one outstanding pattern in today's professional outpourings is that "everything is pretty much under control, and if things do get serious the Federal Reserve Board merely has to open the monetary faucets—thereby sending the stock and bond markets into the stratosphere again."

Few if any of today's analysts see events in terms of the great overriding force of the market, the primary trend. Almost to a man they are thinking in terms of "a further slight decline," "a good rally over the next month or so," "the Dow will be in the 840-860 zone by the end of the year."

The fundamental concept of the primary trend is so simple and all-encompassing that it seems to escape the minds of the analysts. But there is a reason for this: men do not like to think of themselves as caught in a tide of events. They do not like to think in terms of an immutable, all-powerful force which is bigger than the President, bigger than the Congress, bigger than all the governments of the world combined. Man, given the proper equipment and enough intelligence, can do anything—or so goes the thinking of the vast majority of investors.

But there is a law of the markets (and of life, for that matter) that has never been suspended. The essence of that law is that "what goes up comes down," or put another way, "for every force there is an equal counter-force."

The bull market which started in 1949 lasted for 17 years and took the Dow from 161.60 to 995.15. Sooner or later a counter-force (i.e., a primary bear market) will be fated to correct a substantial portion of that 17 year rise. It will correct 17 years of increasing excesses, years of rampant inflation, years of intense speculation, mountains of debt that has seeped, not only into the stock market, but into every segment of American life.

Norman O. Brown, the great writer on psychology, states that the human body is like a theatre, with every gesture, every word, every act, playing out the incredible drama—until at last death takes over, and the drama ends. And since the drama must end in death it assumes the form of a tragedy—no matter how elevated the life of the individual.

It occurs to me that the stock market, too, is a theatre. The first act is serious and intense, as the bull market moves through its early and middle stages. Then as speculation enters and finally pervades the bull market, the mood changes to gay abandon, ecstasy, and the play changes from a somber one to a wild, thrilling melodrama. But ultimately the tragic aspects become clear, as the bull market expires, as the cheers subsdie, as soberness takes over and as the primary bear market relentlessly blots out the last sparks of enthusiasm.

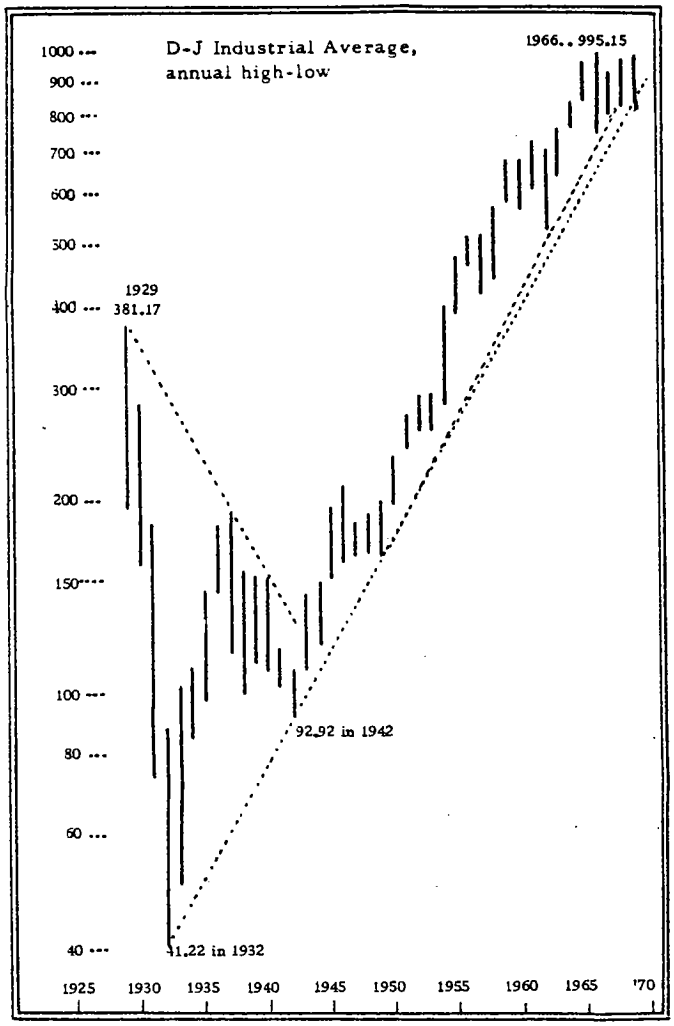
In the final throes of the bear market decline, one looks back and realizes that the whole cycle from bull market and wild profits back to bear market and sorrowful losses is part of the great drama of the market place. The uplifting part of the drama is that out of every bear market's ashes a new bull market (hope) is born. And the tragic part of the drama is that every bull market must end, and with it the dreams of millions of speculators and investors, politicians and statesmen.

The bull market, which began in 1949, ended in 1966, but the bullish actors are still playing their parts, oblivious that the script and mood is changing. They are still keeping their hopes alive with a punch line, a gag, a rally of a month or so. Those who believe that there is no cycle in nature or in the market will follow the bulls to the end—over the cliff and to their own tragic destination. Those who believe that the market, like man, is subject to great natural forces will guide their affairs in harmony with those forces.

I have been telling readers that the bull phase of the drama is over, that the forces of tragedy are slowly and relentlessly taking control. Those who wish to blind themselves via a Presidential announcement here, a move of the Fed there, are welcome to do so.

I believe that in a very short time the tragic phase of the drama will emerge into full view. And the more illusions, the more blindness, the less prepared the actors, the greater the pain when the whole lifeless structure of the bull market ultimately topples over, and the last act of the great drama spreads its truth across the stage.

I seem incapable of getting through any discussion without a chart, and I am therefore including a chart with this section. The accompanying bar-line chart (annual high-low range for the Dow Industrials) shows the path of the Industrial Average since 1929. It seems to me that this chart provides a "feel" of the primary trend.



I have drawn two massive rising trendlines, the longest extending through the 1932 and 1942 bottom, the shorter or more recent one connecting the 1949 and 1962 bottoms. On either reading, "something new" is now occurring. Note on the chart that the upward momentum of the Industrials terminated in 1965 with the Dow range for that year being 969.26 at the high and 840.59 at the low. The year 1966 (which included the bull market top and the low for the bear market so far) provided a range of 995.15 at the high and 744.32 at the low.

All the action since 1966 has occurred within the 1966 range. Since 1966 the Dow has never bettered 995.15, it has never penetrated 744.32. But in holding within the 1966 range the Industrial Average has halted its upward momentum, and thereby penetrated the two great rising trendlines shown on the chart. Thus the upward rate of ascent which has characterized the action of the Dow since 1932 has ended.

Logically, only two possibilities now exist. Either the Dow will ultimately form a new rising trendline from the 1966 or say the 1969 low points, or the Dow is now in the early stages of a major bear market which will serve to correct the bull market which began at 161.60 in 1949.

In my opinion, the latter is the probable meaning of the "interruption" which I have pictured on this chart. The sideways movement of the Dow, holding within the 1966 range, has now lasted just short of four years. My own guess is that the next several years should see action which is far less polite.

WAITING FOR THE SLOWDOWN: Researchers for Sindlinger & Co. report a decline in consumer confidence and a spectacular decline in stockholder confidence. Sindlinger says their figures show that security managers, professional and officials have had their sharpest decline in confidence since 1957. Their conclusion is that this drop in confidence will continue to weaken retail sales and bring on a further weakening in stock prices.

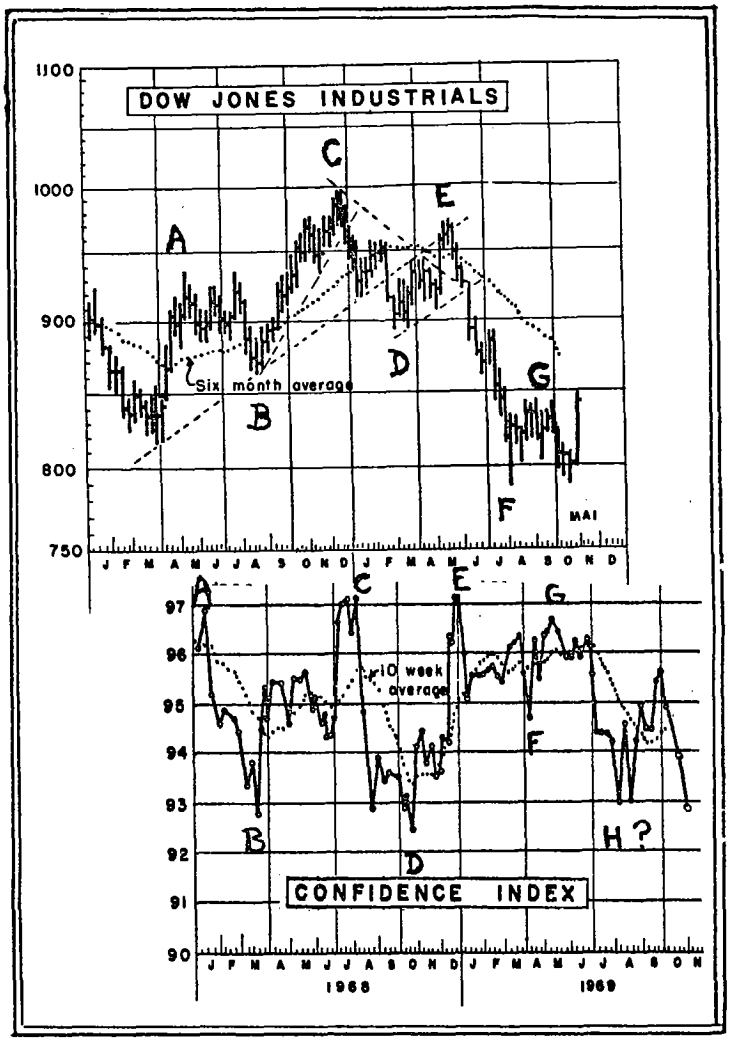
Two weeks ago U.S. News & World Report interviewed business leaders and economists across the nation. Consensus was that business would "slacken" within six months to a year, but that even so prices would continue to march upwards. A "mini-recession" is what bearish economists see for the U.S. in early 1970, but ".....by mid-1970 we'll be back on the upward course."

Both Time and Newsweek headed their business sections with articles about the gathering consumer revolt in the face of higher prices. Newsweek divides the economists into two groups, the sceptics who feel that business will flatten out next year, and the moderates who believe that the nation's G.N.P. will rise about 5%. The famed Pierre Rinfret believes that "we're going to get the greatest economic shock of our lives in the first four months of 1970. There will be no recession—period." Instead, says Rinfret, we're to have "a wildly expanding economy."

Newsweek notes that the mere suggestion that the American economy has escaped their restrictive policies makes Administration economists "shudder in anguish." Time magazine, commenting on the consumers' resistance to higher prices, says: "The new mood—welcome to Washington's inflation fighters but a source of concern to many businessmen—has been building up for months." Business Week (Sept. 27), writing about the Administration "talking up the slowdown," said, "What made the occasion particularly gratifying to Council of Economic Advisers Chairman Paul McCracken was that he at last had the numbers to show that the Administration's policies designed to cool off the economy are working."

So there it is, Washington is waiting breathlessly for signs and hints of something resembling a mini-recession or at least a slowdown. Personally, I am very much afraid that before 1970 is out Washington is going to have all the slowdown it will ever want to see.

CONFIDENCE INDEX: What ever happened to Barron's Confidence Index, which was followed so widely four or five years ago? Nothing, Barron's still publishes the statistics weekly—but nobody ever mentions the CI any more. It was simply a case of too many people following the same indicator. When that happens, the given indicator invariably falls out of favor, and that is what has happened to the old Confidence Index. But when everyone drops a once-reliable market indicator, I start watching it again.



Briefly, the CI is the ratio of high-grade bonds to the D-J 40-Bond Index (the latter is a broad cross-section index of all bonds). When investors move into high-grade bonds the CI declines. This means that investors are moving towards the safety of the highest grade bonds, presumably because they are becoming worried about the future. Conversely, when bond buyers feel more confident about the picture ahead, they foresake the safety of high-grade bonds in favor of the more attractive yields of lower grade bonds. When this occurs the CI rises.

Traditionally, as Joe Granville observed in his detailed CI studies, the CI may lead the Dow Industrials by 2 to 4 months. The rationale behind this is that sophisticated bond buyers tend to see the trend of events before the less sophisticated stock buyers. The actual lead-interval seems to vary from period to period, from market to market.

I have arranged the charts of the CI and the Dow so that the CI leads the Dow by a little over 4 months. I have drawn a series of points from A through H, and subscribers may note that there now seems to be a good correlation between the advance movements of the CI (on a 4-month lead basis) and the Dow.

Historically, the direction of the CI is more important than the amplitude of movements. In other words, the CI is better at showing when a reversal will occur than it is at showing the extent of the movement following the reversal. At any rate, the chart would seem to speak for itself. I interpret it as saying that the period around November to December is due for a sharp reversal to the downside. This downward movement is designated by the decline in the CI from G to H on the chart (Charts for this study courtesy of Merrill Analysis, Box 228, Chappaque, New York 10514).

NOTES & QUOTES: The first quote doesn't need any comment. This clip is from the Oct. 14 issue of the authoritative Weekly Bond Buyer

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By Conrad Christiano

WASHINGTON—In the first quarter of the current year, the nation's balance-of-payments picture was described by Government officials who had the most to do with it as "poor, leaning to bad." In the second quarter, the same officials characterized the deficit as "bad, leaning to worse." In the third quarter, judging from very preliminary figures, the balance-of-payments deficit has finally arrived—it is very bad.

What's more, if things continue at their present pace for the remaining three months of the current year, the United States will have chalked up in 1969 the worst balance-of-payments deficit to be incurred since Government numbers-watchers first began tabulating such things.

Prime candidate to set off a crisis is now "disintermediation" or the run-off of deposits from savings institutions, savings & loan companies and commercial banks. From all sources the word is that the public is becoming sophisticated; that they are getting wise to the huge premiums offered by bonds over bank deposits. Most of the big, "smart" money has already left the thrift institutions, and since June, 1969, mortgage lending by S & L's and savings banks has virtually come to a standstill.

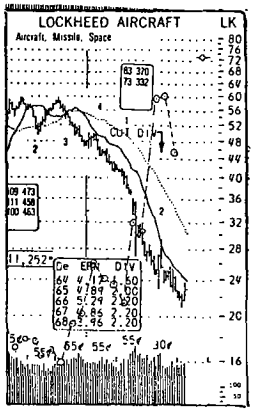
What worries these institutions is the flight of the $10,000 to $25,000 class of depositors. On Oct. 15, the Wall Street Journal carried a front page article on the new Mecca for the little man, the bond market. One broker was quoted as saying that six months ago 90% of his bond trading was done by institutions, 10% by the public. Now, he claims, the situation is reversed.

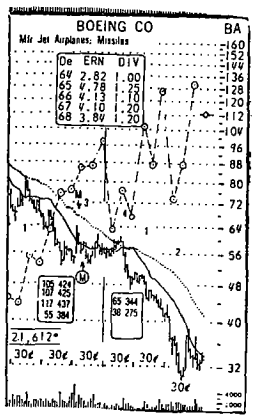
MILITARY: Volumes have been written on the great American military-industrial complex. So much emotionalism is connected with the military and military procurement that no one has ever come up with the answer of how much this nation needs to spend on defense. But one thing is certain— U.S. hardware has armed most of the free world and much of the twilight world. The U.S. arms business is the most titanic manufacturing complex ever to appear on the face of the earth.

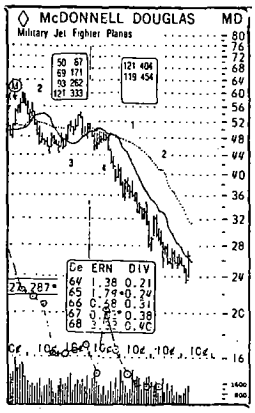
Now the cost of arming the U.S. and the world (and lending the rest of the world money to buy our arms) is beginning to tell. And President Nixon has decided to cut back. On October 20 the latest rumor hit the headlines: The U.S. may cut back its armed forces to the tune of half a million men.

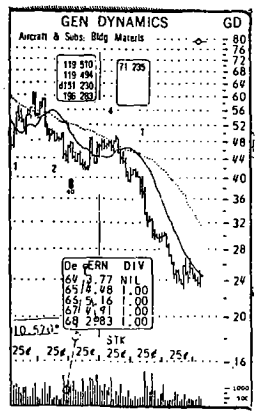
I include the weekly charts of five of America's prime military suppliers, all listed on the N.Y.S.E. An examination of these charts suggests that all is not profits with the military suppliers. Some may read even more into these charts than that (charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).

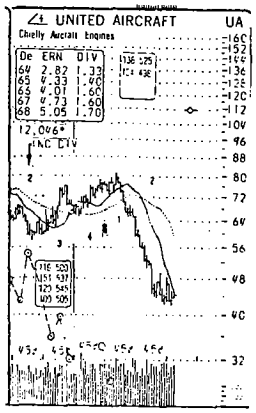
I also include a cartoon from Het Parool, one of the leading Dutch newspapers. The cartoon points up the burden which Mr. Nixon is now carrying. From all accounts, Mr. Nixon wants badly to get this weight off his back. In time, he will have to do it. That is what the five stock charts below are gauging.











Behrendt in HET PAROOL, Amsterdam